

STREAMLINED SALES TAX

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In recent years, the popularity of the Internet has contributed to a significant increase in remote transactions, in which items are purchased from out-of-state sellers. This article discusses the impact electronic commerce is having on states' sales tax revenue, and proposals that have been made to address this development.

Background

Within the tax systems of most states, the sales tax is an important component. Forty-five states and the District of Columbia levy a sales tax on most retail purchases, and several of these states also allow local units of government to levy the tax. Reportedly, there are over 7,000 state and local taxing jurisdictions that levy a sales tax. Nationwide, the sales tax generates over one-third of total state and local government revenue.

What is commonly thought of as the sales tax includes both sales and use taxes. In a state that levies a sales tax, the tax applies to the vast majority of retail transactions (other than those specifically exempted) that occur in that state; however, if the state's residents purchase goods outside their state, then the use tax may apply. Each state that has a sales tax also has a similar use tax, which must be paid by buyers who use, consume, or store in-state items that were purchased out-of-state. The use tax is a necessary companion to the sales tax, because without it residents could avoid much of the sales tax by making as many purchases as possible outside their state. Traditionally, states have required sellers (retailers) to collect sales tax on taxable sales and remit the tax to the states for transactions within an individual state's borders. Retailers must collect sales tax on a purchase whether the purchaser is a resident or a nonresident, if the purchaser takes possession of the product. In general, if products are shipped to nonresident purchasers, the seller is not required to collect sales tax, but the purchasers are required to pay the use tax in their home state.

This system is efficient for transactions involving products that must be registered, such as a car. If a Michigan resident buys a vehicle in Ohio, for example, he or she must pay the use tax on the purchase price when registering the vehicle in Michigan. The system does not work as well for other purchases. If the same Michigan resident orders a box of decorative, laminated buckeyes from Ohio, the Michigan Department of Treasury is not likely to have any record of the transaction, and thus will collect no use tax unless it is voluntarily remitted by the purchaser, or voluntarily collected and remitted by the seller. Historically, voluntary compliance with the use tax by individuals is extremely low because people are unaware that the tax exists or they ignore it. Voluntary compliance by remote sellers (businesses outside a state's borders) has likewise been rare.

Attempts by various states to require a remote seller to collect and remit use tax on merchandise sold to a state's residents have been restricted since 1967 by two key U.S. Supreme Court decisions. In 1967, the Court ruled that an Illinois statute requiring an out-of-state mail-order business to collect and pay use tax on goods purchased for use in Illinois violated the Due Process Clause of the U.S. Constitution and created an unconstitutional burden on interstate commerce (*National Bellas Hess, Inc. v Department of Revenue of Ill.*, 386 U.S. 753). In a subsequent use tax collection case, North Dakota filed an action in state court to require an out-of-state mail-order house to collect and pay use tax on goods purchased from it for use in North Dakota. The case eventually went to the U.S. Supreme Court, which affirmed its earlier ruling in *Bellas Hess*; held that, for a state to require a business to collect sales or use tax, the business must have a physical presence (nexus) in the state; and found that Congress could legislate a solution because it had the constitutional authority to regulate commerce among the states (*Quill Corp. v Heitkamp*, 504 U.S. 298 (1992)).

The Internet Challenge

Until the middle to late 1990s, individual purchases from remote sellers primarily were made through catalog sales. While the inability of states to collect use tax was troublesome, it was not critical to state budgets. In recent years, however, the growth of transactions made over the Internet has substantially increased the incidence of remote

sales, and a further increase in remote sales via the Internet is widely considered likely. This means that, nationwide, the percentage of transactions subject to the sales tax (and mandatory tax collection) is decreasing, while the percentage of transactions subject to the use tax (dependent on voluntary remittance) is increasing.

There is concern among many of the 45 states (and the District of Columbia) that levy sales and use tax that the ever-increasing volume of purchases over the Internet and by mail order is seriously eroding sales and use tax revenue, and that this erosion will grow dramatically over time. Documents from the National Conference of State Legislatures (NCSL) state that business-to-consumer electronic-commerce sales amounted to \$3 billion in 1997 and \$45 billion in 2000, and are projected to total \$140 billion by 2003. A widely reported study by the National Tax Association and the University of Tennessee projects that the 45 states with sales tax will forgo over \$10 billion in uncollected tax on e-commerce transactions in 2003. In states that rely heavily on sales and use tax revenue, the combination of increased remote sales and a continuing inability to tax those sales presents a threat to those states' budgets. In Michigan, approximately 35% of total State tax revenue is from sales and use taxes, and 73% of sales tax revenue is dedicated to the State School Aid Fund.

Main Street and Congress

The states are not alone in their concerns regarding the evolution of sales and use taxes. "Bricks vs. clicks" has become a common phrase to describe the difference between "Main Street" merchants and Internet businesses. While the Main Street seller must collect sales tax on transactions, and therefore must include the tax in the final price, an Internet business with no physical presence in a state may send purchased goods to customers in the state without charging sales tax. The Main Street seller thus is considered to have a pricing disadvantage to remote sellers who offer similar products. Brick-and-mortar retailers worry that, over time, as more and greater remote sales take place, they will fall behind Internet sellers despite the shipping costs usually associated with Internet purchases.

Many have long believed that the problems states face because of remote sales will never be solved without Federal intervention. As mentioned above, the U.S. Supreme Court in *Quill* stated that Congress could legislate a nationwide solution because it has the authority to regulate commerce among the states. To date, Congress apparently has been reluctant to assist the states regarding taxation of remote sales, as proposals to address the issue have not been adopted. In 1998, Congress did pass the Internet Tax Freedom Act, which established a three-year moratorium on state taxes on Internet access and on multiple taxes on Internet transactions. (Contrary to some reports, the Act did not prohibit states from attempting to collect sales and use taxes on Internet purchases.) The moratorium was adopted, reportedly, to encourage the development and accessibility of the Internet and Internet-related businesses. The moratorium is scheduled to expire in October this year. Some members of Congress have introduced legislation not only to extend the moratorium, but also to prohibit the taxation of any Internet activity, including imposition of sales tax.

Response from the States

States dependent upon the sales tax as a principal revenue source view the recent developments with varying degrees of alarm. Many state officials have come to believe that the complexity of the sales tax systems is the key impediment to a solution; that is, if the current sales tax systems among the various states can be simplified so that remote sellers do not view the sales tax as a burden, perhaps those businesses will be agreeable to cooperating with the states, the Supreme Court will look more favorably on the taxation of remote sales, and Congress will be less likely to impose a nationwide solution that the states would find unsatisfactory. In response, in 2000, the NCSL, the National Governors' Association, the Multistate Tax Commission, the Federation of Tax Administrators, and state revenue officials began to develop model legislation to encourage states to enter into multistate discussions to develop and implement a uniform simplified sales and use tax agreement. The parties developed two similar versions of the model, the Streamlined Sales Tax Project and another NCSL model, that establish the framework for the creation of a multistate agreement.

Both of the models attempt to streamline and simplify the administration of sales and use taxes. Details of the models are far too extensive to describe in this article; however, the models would do the following:

- Provide for the voluntary registration of sellers, who would select a method for the collection and remittance of sales and use taxes.
- Allow sellers to contract with certified service providers for the collection and remittance of taxes; and establish qualifications for certification as a service provider.
- Provide for the use of an automated system that would calculate each jurisdiction's tax on a transaction; and establish requirements for certification of an automated system.
- Provide for consumer privacy.
- Establish uniform standards for the identification of taxing jurisdictions; the administration of exempt sales; and sales and use tax returns and remittances.

As of June 6 this year, the models had been introduced as legislation in 27 states. One or the other model has been signed into law in 12 states: Arkansas, Indiana, Kentucky, Louisiana, Maryland, Nebraska, Nevada, North Dakota, Oklahoma, Tennessee, Utah, and Wyoming. The Texas, Florida, and Illinois legislatures have adopted the NCSL model and sent the legislation to their governors. A model is expected to be adopted in several other states this year. In Michigan, the Senate has passed a proposal based on the NCSL model. Senate Bill 433 (S-4) is currently in the House Tax Policy Committee.

Further Issues

Despite movement toward a multistate streamlined sales tax agreement, many issues remain unresolved. Opposition to the taxation of remote sales remains strong from e-commerce businesses, and those who are philosophically opposed based on the belief that efforts to collect remote sales tax amount to new or additional taxation. It appears that Congress may be leaning toward further connecting the Internet tax moratorium to the remote sales issue. According to a June 14, 2001, report in *USA Today*, one proposal before in the U.S. Senate would extend the moratorium on new Internet taxes to 2006, but would give the states five years to develop a plan to simplify their sales tax systems. If Congress approved the plan, it would allow the taxation of Internet and mail order sales, but the plan would have to include uniform definitions of goods and services, as well as one national sales tax rate or one rate per state for Internet and mail order sales. Among the states with sales tax, there are numerous definitions of goods and services (which prescribe those transactions to which the tax applies). There also is a wide range of exemptions and partial exemptions, not only among the states but, in some states, among different local units. Further, there are numerous sales tax rates among the states, and in many states local units are allowed to charge rates that differ, or are in addition to, the state rate.

It is questionable whether the various taxing jurisdictions could agree on a single tax rate for remote sales, let alone agree to standard definitions and exemptions. The NCSL has gone on record as opposing any Congressional legislation that requires one sales tax rate per state for remote sales, stating that an agreement on one rate is unattainable in a dozen or more states. It remains to be seen whether enough states will be able to develop a workable streamlined sales tax system in which businesses will voluntarily participate, or whether this goal can be accomplished prior to unwanted Congressional mandates or absent acceptable Congressional participation.

(For detailed information about Senate Bill 433 (S-4), the proposal passed by the Michigan Senate, please see the Senate Fiscal Agency analysis at <http://michiganlegislature.org>. Additional background information may be found in a 1999 Senate Fiscal Agency issue paper, "Taxation of Electronic Commerce", available at <http://www.senate.state.mi.us/sfa/>. The documents also may be requested from the Senate Fiscal Agency.)